

di•ver•si•fi•ca•tion (dī-vûr' sə-fī-kā'shən) An investment technique which reduces the risk of the overall portfolio by investing in a large number of uncorrelated assets. The process helps to mitigate exposure to individual firm-specific risks. Diversification also helps to give much more normalized returns over time. By investing in different companies or assets no individual asset can have a dramatic impact on the total value of the portfolio.

Federal Reserve System (fed' ər-əl rī-zûrv' sîs'təm) The Central Bank of the United States. The Federal Reserve System (or more commonly “The Fed”) regulates the money supply, prints money, fixes the discount rate and issues government bonds with the goal of providing stability to the overall US economy. The system is controlled by a chairman (currently Ben Bernanke) and seven committee members (or ‘governors’) who are all appointed by the president of the United States.

fi•du•ci•ar•y (fī-dōō' shē-ěr' ě) An entity, either an individual, corporation or association, which exercises discretionary authority over the assets of a plan, provides management or administrative functions, controls disposition of its assets, or renders investment advice for a fee.

Introductory Section

Defining the Foundation of Your Retirement Plan

Introductory Section

Mark Sanford, Chairman
Governor

Grady L. Patterson, Jr.
State Treasurer

Richard Eckstrom
Comptroller General

State Budget and Control Board South Carolina Retirement Systems



Peggy G. Boykin, CPA
Director

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Chairman,
Senate Finance Committee

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Chairman,
Ways and Means Committee

Frank W. Fusco
Executive Director

LETTER OF TRANSMITTAL

November 1, 2006

The Honorable Mark Sanford, Governor
and
State Budget and Control Board
State of South Carolina

Gentlemen:

We are pleased to present the *Comprehensive Annual Financial Report* (CAFR) of the South Carolina Retirement Systems for the fiscal year ended June 30, 2006. The South Carolina Retirement Systems is required by Section 9-1-300 of the South Carolina Code of Laws to publish annually a report of the fiscal transactions of the system and this CAFR fulfills that statutory requirement. Since the Retirement Systems is a part of the primary government of the state of South Carolina, the Systems' financial information is also included in the comprehensive annual financial report of the State. Responsibility for both the accuracy of the data, and the completeness and reliability of the presentation, including all disclosures, rests with the management of the Systems. To the best of our knowledge and belief, the enclosed data are accurate in all material respects and are reported in a manner designed to present fairly the financial position and results of the Systems.

The CAFR was prepared to conform to the principles of governmental accounting and reporting set forth by the Governmental Accounting Standards Board (GASB). Transactions of the Systems are reported on the accrual basis of accounting. Sufficient internal accounting controls exist to provide reasonable assurance regarding the safekeeping of assets and fair presentation of the financial statements and supporting schedules. The financial statements presented in this CAFR have been independently audited by Rogers & Laban, PA, Certified Public Accountants, under the direction of the State Auditor's Office. Rogers & Laban issued an unqualified opinion, which means that based upon the audit, they concluded that the financial statements were fairly presented in all material aspects and free from material misstatement. Although independent auditors cannot guarantee the accuracy of the statements, they do have a reasonable basis for the opinion they render. The independent auditor's report is presented as the first component of the financial section of this report.

The 2006 CAFR is presented in five sections:

- The **Introductory Section** contains the letter of transmittal, identification of the Systems' administrative organization, and descriptions of administrative responsibilities.
- The **Financial Section** contains the opinion of our independent auditors, Management's Discussion and Analysis (MD&A), basic financial statements and required supplementary information and schedules.
- The **Investment Section** contains schedules of investments and investment growth, a report from the State Treasurer, and a report from our Chief Investment Officer.

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- The **Actuarial Section** contains certification letters from our independent consulting actuaries, the results of the annual actuarial valuations, a summary of plan provisions for each System, and other actuarial related information.
- The **Statistical Section** contains various tables and schedules of significant data pertaining to the Systems.

Profile of the Systems

The South Carolina Retirement Systems administers five defined benefit pension plans that provide lifetime retirement annuities, disability benefits and death benefits to eligible members. The plans' terms specify the amount of pension benefits to be provided at a future date or after a certain period of time. The amount specified is a function of a formula based on years of service, compensation and age. Our administrative and reporting structure is outlined in the introductory section of this report.

This report contains information on the following defined benefit pension trust funds:

- The South Carolina Retirement System (**SCRS**) was established July 1, 1945, to provide retirement and other benefits for teachers and employees of the state and its political subdivisions.
- The Police Officers Retirement System (**PORS**) was established July 1, 1962, to provide retirement and other benefits to police officers and firefighters.
- The Retirement System for Members of the General Assembly of the State of South Carolina (**GARS**) was established January 1, 1966, to provide retirement and other benefits to members of the General Assembly.
- The Retirement System for Judges and Solicitors of the State of South Carolina (**JSRS**) was established July 1, 1979, to provide retirement and other benefits to state Judges and Solicitors.
- The National Guard Retirement System (**NGRS**) was established July 1, 1975, to provide supplemental retirement benefits to members who served in the South Carolina National Guard. Legislation transferred administrative responsibility of the plan from the Adjutant General's Office to the South Carolina Retirement Systems effective January 1, 2006.

Fiscal Year 2006 Highlights

Fiscal year 2006 was yet another dynamic and challenging year for the South Carolina Retirement Systems. The Retirement Systems not only continued to experience a higher workload trend due to customer demand, but also had considerable systems modifications and process changes to make in response to significant legislative changes. The State Retirement System Preservation and Investment Reform Act became effective July 1, 2005. As a part of this legislation, SCRS retirees are guaranteed to receive a pre-funded 1 percent cost-of-living adjustment (COLA) each year. Subsequent to fiscal year-end, a referendum to amend the state constitution to allow full diversification of the South Carolina Retirement Systems' investment portfolio was passed. If ratified, the amendment will permit the South Carolina Retirement System Investment Commission to invest the trust funds in a more diverse group of investments and among more asset classes, which will allow the Retirement Systems' trust funds to be on a level playing field with other public retirement funds across the nation.

State Retirement System Preservation and Investment Reform Act

The South Carolina General Assembly passed Act 153, the State Retirement System Preservation and Investment Reform Act, effective July 1, 2005. This sweeping legislation guaranteed and pre-funded a COLA for eligible SCRS retirees. If the Consumer Price Index (CPI) increases no more than 1 percent, the COLA for SCRS is equal to the percentage increase in the index. If the CPI increases by more than 1 percent, the South Carolina Budget and Control Board is authorized to approve an additional COLA for SCRS beyond the 1 percent up to the lesser of the CPI or 4 percent. Legislation also requires that funding requirements have been met considering all unrealized investment gains and losses. The guaranteed 1 percent COLA cost SCRS more than \$2 billion; a cost which was spread among increased contributions from employers

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and active employees, and the requirement for retired members to make employee contributions while working for a covered employer. South Carolina's retirement plan is one of the most flexible public plans in the nation in that it allows retired members to continue receiving their annuity benefit while working. In addition, Act 153 provided death benefits to contributing working retirees. The legislation also required retired members of SCRS and PORS who either participate in the Teacher and Employee Retention Incentive (TERI) program or return to covered employment as a working retiree, to make employee contributions to the system. Active TERI participants and working retirees who retired and returned to work prior to July 1, 2005, challenged the requirement that they pay member contributions and the South Carolina Supreme Court ruled in favor of the TERI participants. For further details, see Note VIII on page 44. However, working retirees currently have a lawsuit pending against SCRS in which they are seeking to overturn the requirement that they make employee contributions if they return to covered employment. Should the court rule against SCRS, the cost would have to be shifted to and absorbed by either employers or active employees.

Act 153 increased the SCRS employee contribution from 6.0 percent to 6.25 percent effective July 1, 2005, and from 6.25 percent to 6.5 percent effective July 1, 2006. The Act also increased SCRS employer contributions from 7.55 percent to 8.05 percent effective July 1, 2006, and included an increase to 8.55 percent effective July 1, 2007. Employer contributions were further increased by an additional .51 percent to 9.06 percent effective July 1, 2007, to maintain SCRS' 30-year amortization period, which was jeopardized due in large part to the negative effect of a ruling by the South Carolina Supreme Court during the fiscal year, and to a lesser degree, to fund the ad hoc COLA approved by the Budget and Control Board effective July 1, 2006. The Court's ruling resulted in an estimated loss to SCRS of \$124 million in employee contributions and necessitated a shift of this funding from the TERI program participants who formerly were required to make employee contributions to employers. The Budget and Control Board increased employer contributions by the .51 percent to maintain the 30-year amortization period as required.

South Carolina Retirement System Investment Commission

In addition to the changes discussed above, Act 153 established the six-member South Carolina Retirement System Investment Commission, which is made up of financial experts, the State Treasurer and a nonvoting retired member; moved fiduciary responsibility for all investments to the Commission; provided that equity investments cannot exceed 70 percent of the total investment portfolio (formerly 40 percent); and created the position of Chief Investment Officer (CIO). This part of Act 153 was effective October 1, 2005. By statute, the CIO develops and maintains annual investment plans as approved by the Commission and, as an agent of the Commission, oversees the investment of Retirement Systems' funds. The assets of the Retirement Systems are managed externally by professional investment managers approved by the Commission. As of June 30, 2006, the Commission, which is fully responsible for the Retirement Systems' portfolio, utilized 18 outside active managers and the State Treasurer's Office to assist with equity investments and fixed income assets, respectively. The Commission is an independent agency with additional professional and administrative staff that assists in the monitoring of investment managers and in implementing the Commission's decisions.

Transfer of Administration of the South Carolina National Guard Retirement System

Effective January 1, 2006, the South Carolina Retirement System assumed administrative responsibilities for the National Guard Retirement System (NGRS) which is a defined benefit pension plan providing supplemental benefits to National Guard members who served in South Carolina. This plan was previously administered by the Adjutant General's Office. At June 30, 2006, the plan's net assets are valued at \$12.9 million and will be invested in the same manner as the funds of the other four pension trust funds administered by the Retirement Systems. Contributions for the NGRS are provided by annual state appropriations based on the annual required contribution determined annually by the actuary. The legislature has made the commitment to contribute the required contributions during the fiscal year for which they are due and over time, this commitment will improve the actuarial soundness of the plan. Approximately 2,900 retired members were added to the Retirement Systems' annuitant payroll and another 5,800 active and inactive members were added to our rolls. The NGRS has been closed to new entrants since July 1, 1993; however, recent legislation reopens the system effective January 1, 2007, to any new entrants since June 30, 1993.

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Project Management Officer Position Created

The South Carolina Retirement Systems hired a project management officer (PMO) to assist in meeting the division's goals in providing service to its customers. The PMO position was created as a result of the strategic planning process and will be a vital component in the determination of future strategy and planning.

Teacher and Employee Retention Incentive Program Participation Dropped

The Teacher and Employee Retention Incentive (TERI) program continued to remain attractive to our membership. The program, which was implemented in January 2001, allows retired members to accumulate deferred annuity benefits for up to 5 years while continuing employment. December 2005 marked the end of the five year deferral period for participants that joined the plan at its inception; therefore, the plan experienced a significant increase in the amount of accumulated benefits distributed this fiscal year. As a result of the distributions, the amount of assets held in trust for future payment of accrued benefits actually decreased for the first time by 24 percent, leaving a balance of \$671 million at fiscal year-end.

For the past several fiscal years, a myriad of legislation has been proposed in the South Carolina General Assembly to repeal or otherwise change the existing TERI program; however, with the exception of Act 153, these bills have been the subject of much discussion but have not been adopted by the Legislature. TERI continues to be a very controversial issue and threat of possible repeal again contributed to the large number of new participants taking advantage of TERI. Act 153, referred to earlier, did exempt all new TERI participants from state grievance rights and requires them to make employee contributions to the system while participating in the program.

Rankings Among Peer Pension Plans

The South Carolina Retirement Systems participates in an annual public pension plan benchmarking analysis conducted by Cost Effectiveness Management, Inc., (CEM). Fifty-four public pension plans participated in the 2005 CEM survey, which marked the fifth year of participation for the Retirement Systems.

Although the Retirement Systems is a customer centric organization, we are also a division of South Carolina state government and as such, must adhere to stringent budgetary guidelines. According to the CEM report, the South Carolina Retirement Systems' total adjusted administrative cost per member was \$47 in comparison to a peer median cost of \$80, the fourth lowest cost among all 54 participants. Our low administrative cost is achieved through the efficient and proactive deployment of automated systems and appropriately allocated human resources.

While the Retirement Systems has continued to provide quality services at a low cost despite brutal workload demands, we believe that we are beginning to fall behind our peers. Our infrastructure, particularly our information systems, has been stagnated by mandatory changes required by legislation and court rulings. If the Retirement Systems is to continue to provide high quality service levels, we cannot continue to do so at this pace and must expend the resources necessary to both maintain our infrastructure and expand our technological abilities. Doing so will allow us to divert some of our excessive workload from human to technological resources, thereby providing a more reasonable workload for our staff and the opportunity to keep up with customer needs.

Summary of Financial Condition

The funding objective of the pension trust funds is to meet future benefit obligations of retirees and beneficiaries through contributions and investment earnings. Our external consulting actuaries determine the actuarial soundness of the plan based on its long term obligations and the sufficiency of current contribution levels to fund the liabilities of each plan over a reasonable time frame. In our most recent valuations dated July 1, 2005, our actuarial consultants concluded that the Systems are operating on an actuarially sound basis. Governmental accounting standards require that the maximum acceptable amortization period for the total unfunded actuarial liability is 30 years and all five systems are considered adequately funded within GASB standards. The funded ratio for the SCRS, which represents the largest membership of the five plans, decreased from 80.3 percent to 71.6 percent. The change was due largely to plan provision changes related

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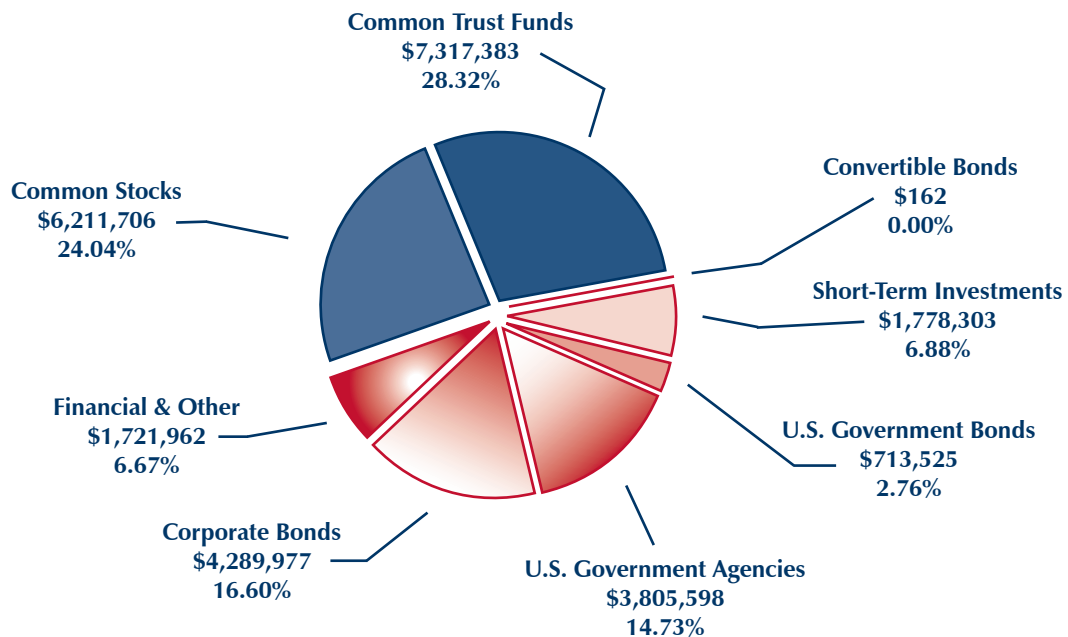
to legislation, which included a 1 percent guaranteed COLA, but also by a 2.4 percent ad hoc cost-of-living adjustment (COLA) that was granted effective July 1, 2005, as well as investment and non-investment related experience losses. In fact, the largest percentage of the drop in SCRS' funded ratio is attributable to the more than \$2 billion cost to guarantee and pre-fund the 1 percent COLA. As a result of these and other factors, the amortization period for SCRS' unfunded actuarial accrued liability increased from 27 to 30 years. The current funded ratios of the five plans range from a low of 25.9 percent for NGRS to a high of 87.4 percent for PORS. More detailed information regarding the financial condition of the pension trust funds can be found in the financial and actuarial sections of this report.

An optimally diversified investment portfolio is designed to provide long-term returns. While our past investment performance has been limited by our State constitution and State statute, the custodian of our assets, the State Treasurer, and the Investment Commission work diligently to ensure our investment strategy is pragmatic and conservative, while providing competitive returns. Increasing our exposure in equity markets from 40 percent toward the 70 percent ceiling will reduce risk while providing increased opportunities for investment gains and will allow us to keep pace with other similar public funds.

For the year ended June 30, 2006, the combined Systems investment portfolio produced a total aggregate investment return of 5.13 percent. Although current year performance lagged behind our peer groups and did not reach the actuarial assumed rate of 7.25 percent, the actuarial smoothing methodology offsets the shortfalls against other investment gains over a five-year period to mitigate market volatility.

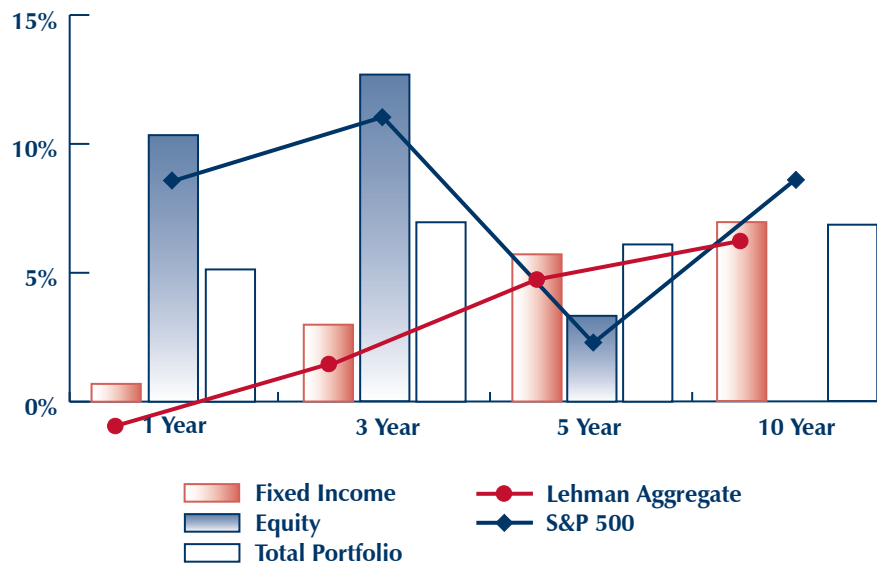
The chart below and at the top of Page 12 summarize the Retirement Systems' asset allocation and overall investment performance in comparison to the relevant benchmarks.

South Carolina Retirement Systems Schedule of Asset Allocation
Market Value of Investments as of June 30, 2006
(Dollar amounts expressed in thousands)



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South Carolina Retirement Systems Summary of Investment Performance as of June 30, 2006



Investment performance is a significant factor in our actuarial valuations. As referred to earlier, our actuarial consultants use an actuarial asset valuation method that recognizes a portion of the difference between the actual market value of assets and the expected actuarial value of assets, based on the assumed investment rate of return of 7.25 percent. This method recognizes 20 percent of the difference between market and expected actuarial value each year and guarantees that any gain or loss is recognized over a five-year period. The actuarial value of assets is limited to a range between 80 percent and 120 percent of market value. This actuarial asset valuation method dampens year-to-year fluctuations, smoothes the effect of volatility in the market and helps provide a consistent estimate of the value of assets. Detailed investment results for fiscal year 2006 can be found within both the financial and investment sections of this report.

It is paramount to note that SCRS is considered actuarially sound and both benefits and a 1 percent COLA are funded based on current contribution levels; however, any additional COLAs beyond the 1 percent in SCRS are not prepaid. If the intent of the Systems, the Board, or the Legislature is to provide additional COLA benefits, it is imperative that some additional funding mechanism be established.

For additional financial information, please refer to the management's discussion and analysis, financial statements and schedules included in the financial section of this report.

Certificate of Achievement

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the South Carolina Retirement Systems for its Comprehensive Annual Financial Report (CAFR) for the fiscal year ended June 30, 2005. The Certificate of Achievement is a prestigious national award recognizing excellence in the preparation of state and local government financial reports.

In order to be awarded a Certificate of Achievement, a government unit must publish an easily readable and efficiently organized comprehensive annual financial report, the contents of which meet or exceed program standards. The CAFR must satisfy both generally accepted accounting principles and applicable legal requirements. A Certificate of Achievement is valid only for a period of one year. The Systems has received a Certificate of Achievement for each of the last 19 consecutive years (fiscal years ended 1987-2005). We believe this 20th issue of our annual report continues to conform

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to the Certificate of Achievement Program requirements, and we are submitting it to the GFOA for consideration again this year.

Public Pension Standards Award

The South Carolina Retirement Systems also received the Public Pension Coordinating Council's Public Pension Standards 2006 Award. This is the third consecutive year during which the Retirement Systems applied for and received the Council's award in recognition of meeting professional plan design and administration standards. The Public Pension Coordinating Council is a confederation of the National Association of State Retirement Administrators, the National Conference on Public Employee Retirement Systems, and the National Council on Teacher Retirement.

Acknowledgments

The compilation of this report reflects the combined efforts of the staff of the South Carolina Retirement Systems functioning under your leadership. The report is intended to provide comprehensive and reliable information about the Systems, to demonstrate compliance with legal provisions, and to allow for the evaluation of responsible stewardship of the funds of the Systems.

We express our gratitude to the members of the Board, the staff, the consultants, and the many people who have worked so diligently to assure the continued successful operation of the Systems.

Respectfully submitted,


Peggy G. Boykin, CPA
Director


Tammy B. Davis, CPA
Assistant Director, Financial Services





Governing Board and Administration

Governing Board - SC State Budget and Control Board

| | |
|-------------------------|--|
| Mark Sanford, Chairman | Governor |
| Grady L. Patterson, Jr. | State Treasurer |
| Richard Eckstrom | Comptroller General |
| Hugh K. Leatherman, Sr. | Chairman, Senate Finance Committee |
| Daniel T. Cooper | Chairman, House Ways and Means Committee |
| Frank W. Fusco | Executive Director |

Equity Investment Panel¹

| | |
|---------------------------|----------|
| Peter Bristow | Chairman |
| Arthur M. Bjontegard, Jr. | |
| Blaine Ewing, III | |
| Mary M. Kennemur | |
| S. Hunter Howard | |

Retirement System Investment Commission²

| | |
|-------------------------|---|
| Reynolds Williams | Chairman |
| Grady L. Patterson, Jr. | State Treasurer |
| Blaine Ewing, III | |
| James R. Powers | |
| Allen R. Gillespie, CFA | |
| Robert L. Borden | Chief Investment Officer |
| Nancy E. Shealy | Administrative Director and General Counsel |

Equity Investment Consultant

Mercer Investment Consulting, Inc.

Consulting Actuaries

Milliman Consultants and Actuaries
Cavanaugh Macdonald Consulting, LLC

Retirement Systems Executive Management

| | |
|-----------------------|---|
| Peggy G. Boykin, CPA | Director |
| Dianne T. Poston | Assistant Director – Administration |
| Alice R. Copeland | Assistant Director – Customer Services |
| Tammy B. Davis, CPA | Assistant Director – Financial Services |
| Lisa Phipps | Assistant Director – Information Technology |
| Amanda J. Green | Assistant Director – Service/Imaging |
| Stephen Van Camp | General Counsel – Retirement Systems |
| Sarah N. Corbett, CPA | Internal Auditor |

Retirement Systems Staff Responsible for Compilation of CAFR

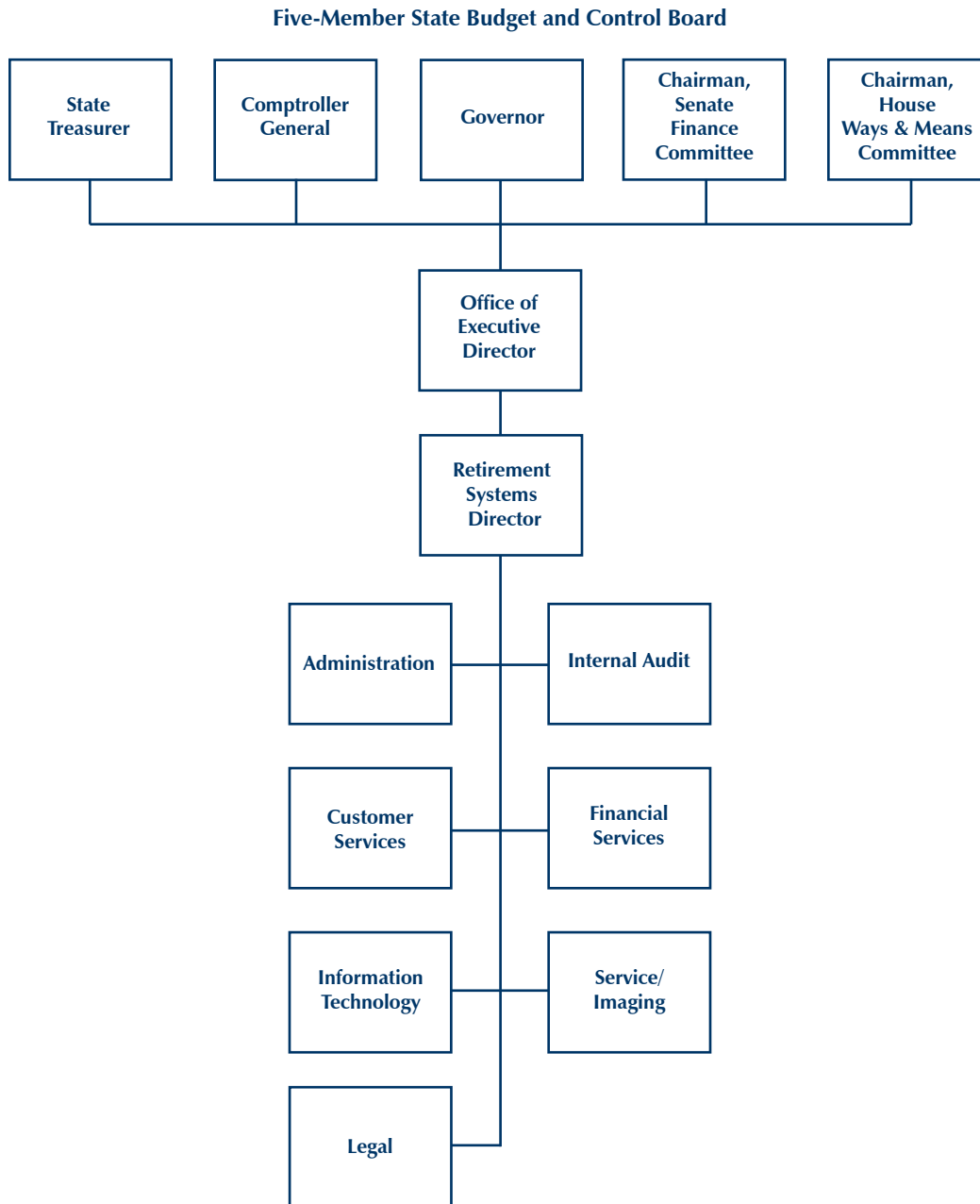
| | |
|---------------------|----------------------------|
| Travis Turner, CPA | Financial Services |
| Ashley Nichols, CPA | Financial Services |
| Faith Wright | Financial Services |
| Megan Reynolds | Public Information Officer |

¹Refer to page 80 for a complete list of equity managers.

²Created by law effective October 1, 2005. See page 9 for more information.

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Organizational Chart



Organizational Description

The structural organization of the Systems is depicted in the organizational chart on page 13. A brief description of the primary functions performed by each department follows:

Internal Audit

Responsible for providing an independent appraisal function to examine and evaluate processes and policies, and for providing assurance to management regarding the internal control structure of the division.

Legal

Responsible for representing the South Carolina Retirement Systems in matters before circuit and appellate courts and administrative bodies, and for providing program support to the management of the South Carolina Retirement Systems.

Administration

Responsible for managerial, budgetary, and administrative oversight of all division operations; physical plant issues, operations, and maintenance; procurement; human resources activities; communications and public information; accounts payable; postal center operations and courier services; and the State Optional Retirement Program.

Customer Services

Responsible for member consultations (in person, by telephone, on-line via the Internet, or by videoconferencing) in all phases of retirement operations; the processing of customer claims relating to annuities, refunds, or death claims; training employers in all aspects of the Retirement Systems' member benefits, reporting procedures, and the Internet accessed employer information system; briefing governing bodies of prospective new employers on member benefits and new employer liability regarding potential costs associated with joining the Retirement Systems; meeting with employees as requested to present benefit overviews and preretirement education programs; and coordinating and conducting retirement seminars designed to better prepare members whose retirement is imminent.

Financial Services

Responsible for all financial reporting and accounting including the preparation of the Comprehensive Annual Financial Report; disbursing monthly payments to annuitants, refunds to terminated members and death benefit payments to eligible members; determining the average final compensation to be used in calculating a member's annuity benefit at retirement; collecting and allocating member and employer contributions; and maintaining membership enrollment and beneficiary information.

Information Technology

Responsible for the design, implementation and control of all automated applications within the Systems.

Service Credit and Imaging Services

Responsible for the computation of the cost for purchases of prior service for all members of the Retirement Systems; the auditing of service credit for our membership; and the maintenance of complete historical records of each member.

Investment Panel Staff

Prior to the October 1, 2005, creation of the South Carolina Retirement System Investment Commission, this staff was responsible for providing legal, research, and administrative support to the State Retirement Systems Investment Panel, and to the South Carolina Retirement Systems and the State Budget and Control Board on issues relating to the Retirement Systems' equity investments.